



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

February 7, 2000

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
2322 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Dingell:

Thank you for your January 5 letter to Attorney General Janet Reno, NASD Regulation President Mary Schapiro, and me concerning issues raised in a December 12 article in the *New York Times* by Gretchen Morgenson entitled "Chasing Ghosts at Nasdaq." This article raised the possibility that Nasdaq share prices may be manipulated by parties creating fictitious quotations of only a few seconds duration in hopes that so-called "momentum" traders will exacerbate short-term price swings.

The Morgenson article also indicated that the parties putting in such phantom quotes may be taking advantage of market structure reforms sponsored by the Commission over the last few years that have given small investors increased opportunities to have their orders reflected in quotations of market makers and trading systems known as Electronic Communication Networks.

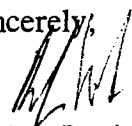
I believe that ECNs have provided much needed competition to Nasdaq market makers over the last few years, and the Commission's order handling rules have offered both small and large investors expanded flexibility and cost savings in having their orders represented on Nasdaq. These reforms have resulted in significant market efficiencies, including narrowing quotation spreads, which ultimately benefit investors. Nevertheless, we must remain vigilant to address any attempts to "game" the improved market access in a manipulative manner.

The enclosed memorandum discusses specific efforts by the NASD and the Commission staff to address the issues raised in the Morgenson article, including surveillance and enforcement programs to identify and prosecute any manipulative scenarios. I want to assure you that I share your commitment to ensuring that evolving market structures do not

The Honorable John D. Dingell
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provide unchecked opportunities to disadvantage investors or compromise market integrity. As always, I look forward to working with you and other Congressional leaders to ensure that the nation's securities markets remain efficient, fair, and honest.

Sincerely,

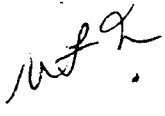
A handwritten signature in dark ink, appearing to be 'AL', written over the word 'Sincerely,'.

Arthur Levitt

Enclosure

MEMORANDUM

TO: Chairman Levitt

FROM: Annette L. Nazareth, Director 
Division of Market Regulation

RE: Phantom Quotes on Nasdaq

DATE: February 2, 2000

In his letter, dated January 5, 2000, to Attorney General Janet Reno, NASD Regulation President Mary Schapiro, and you, Congressman John D. Dingell asked how the Commission was addressing the problems raised in a December 12 article in the *New York Times* by Gretchen Morgenson regarding allegedly manipulative "phantom quotes" in Nasdaq securities. This article, entitled "Chasing Ghosts at Nasdaq," suggested that parties may be attempting to manipulate share prices in Nasdaq securities by creating fictitious quotes of only a few seconds duration that have the effect of raising the best bid quotations or lowering the best ask quotations in particular securities. These short-lived fictitious quotations are allegedly designed to falsely convey to active traders, commonly known as "momentum traders," that the stocks' prices are rapidly rising or falling in hopes that at least some of these traders will then trade in a manner that will exacerbate the short-term price swings in the stocks. The Morgenson article also cited comments from some traders indicating that the parties creating such phantom quotes may be taking advantage of market structure reforms sponsored by the Commission over the last few years that have given small investors increased opportunities to have their orders reflected in the quotes of market makers and trading systems known as Electronic Communication Networks or ECNs.

Overall, the more open market structure that has evolved over the past few years has significantly benefited investors and market professionals. Investors have benefited from the Commission's order handling rules through expanded flexibility and cost savings in having their orders represented on Nasdaq. Moreover, ECNs have provided beneficial competition to Nasdaq market makers. There is generally a consensus that these reforms have resulted in significant market efficiencies that have saved investors millions of dollars on a daily basis. Nevertheless, the Commission and securities self-regulatory organizations such as the NASD must be vigilant to address instances in which parties attempt to misuse the improved market access provided by these reforms in a manner that harms investors or compromises market integrity.

As a preliminary matter, it is important to recognize that many recent instances of rapid order cancellations and quotation changes in volatile Nasdaq stocks appear to reflect capacity limitations in current Nasdaq systems. When high levels of price volatility and heavy inflows

of orders and quotation changes result in queuing on Nasdaq systems such as SelectNet, particularly as the regular trading session begins, delays in price and trade reports may cause some market participants to repeatedly cancel existing orders and enter revised orders as a precaution against receiving executions at unfavorable prices. These cancellations and resubmissions may exacerbate backlogs in these systems, which in turn can result in further cancellations and resubmissions that reinforce the cycle.

The Commission has been working with the NASD on several fronts to address this problem. Specifically, Nasdaq has been striving to increase its system capacity to reduce queuing problems on SelectNet and other Nasdaq systems during peak periods. On January 14, the Commission approved an NASD proposal that is designed to reduce system bottlenecks by modifying Nasdaq's Small Order Execution System to handle some of the order flow that has been overwhelming SelectNet. The recast SOES will be called the Nasdaq National Market Execution System.¹ Nasdaq believes that these changes will improve the speed of executions and increase the access of all market participants to the full depth of a security's trading interest. We will be monitoring the effects of these changes closely over the coming months to determine if further capacity enhancements or structural changes are required to reduce instances of system queuing on Nasdaq, which, in turn, should minimize the need for traders to repeatedly cancel and reenter their orders during peak volume periods. As discussed below, a reduction in the overall levels of rapid quotation changes in Nasdaq stocks would also enhance the ability of surveillance systems to more productively focus on manipulative scenarios.

It is also important to recognize that some aspects of the manipulative scenario raised by traders cited in the Morgenson article involving trading in shares of Diversinet on December 10 were not accurate. While short-term quotation changes cannot be entirely discounted, last sale data do not show that these shares actually traded in the manner described in the article. For example, the traders claimed that on Friday, December 10, Diversinet shares opened around 19, spiked to 25 about 45 minutes later (allegedly due to phantom quotes), and quickly fell back to close at 19 11/16. In fact, last-sale reports indicate that the stock price had been generally trending down since peaking intra-day on December 8 at a price of 29. On Thursday, December 9, the stock traded down from a high of 26 1/4 to close at 23 7/16. In extended-hours trading on December 9, several trades occurred at 23 3/8. In pre-opening trading from 8:00 a.m. to 9:30 a.m. on December 10, Diversinet shares traded as high as 24 1/4, with the 9:30 a.m. opening trade occurring at a price of 23 7/8, reflecting a rise of only 7/16 from the previous day's closing price and a decline of 3/8 from the pre-opening high. The regular session high last-sale price for December 10 was actually 24 (not 25) and was reached at 9:34 a.m. and again at 9:38 a.m. and 9:39 a.m. Thereafter, the price

¹ See Securities Exchange Act Release No. 42344 (January 14, 2000)(SR-NASD-99-11).

decline that had been underway since December 8 resumed, with the stock closing the day at 19 11/16. Nevertheless, while some of the traders' specifics about intra-day trading in Diversinet shares on December 10 appear to have been inaccurate, the possibility of manipulative scenarios involving phantom quotes cannot be ignored.

Several suspicious instances of rapid order changes and quotation fluctuations that appear to have reinforced short-term price swings in certain stocks have been identified by the NASD Regulation staff and the Commission's enforcement staff. For example, the Commission brought an administrative proceeding in 1998 resulting in cease and desist orders against parties who entered and then canceled buy and sell limit orders in Nasdaq stocks with the intention of manipulating the stocks' quotations.² While other inquiries are currently underway, these matters cannot be described in detail in a memorandum that may be made public. As you know, Commission policy generally prohibits comments concerning particular matters that may be the subject of a Commission investigation or any enforcement recommendation that the staff may make to the Commission. In addition to protecting the privacy of individuals and entities whose activities are under investigation, this policy is designed to assure the integrity of the investigative process in appearance as well as in fact.³ If ongoing inquiries provide evidence of manipulative phantom quotes, the Commission staff will recommend that the Commission authorize enforcement actions against the perpetrators. As always, if criminal violations of the securities laws are indicated, these matters will be referred to the Department of Justice for consideration.

In addition, my staff has held discussions with officials at NASD Regulation regarding their efforts to fine-tune current surveillance programs to help distinguish capacity-related cancellations from suspicious patterns of rapid order and quotation changes that result in short-term price swings on Nasdaq. As indicated above, the anticipated overall reduction in order and quotation changes that should result from increased operational capacity and systems realignments underway by Nasdaq should permit NASD Regulation's surveillance program to focus more specifically on suspicious quotation change scenarios. Moreover, NASD Regulation officials indicate that modifications to existing surveillance systems that are being implemented should more effectively identify instances in which large size orders are quickly withdrawn after moving quotation prices significantly in the subject stock. While we cannot discuss the specific time and price-change parameters contemplated for these surveillance enhancements in a memorandum that may become public (as you understand, public discussion of the specific surveillance parameters could provide a "road map" for manipulators to evade detection), the improvements contemplated by NASD Regulation appear to be conceptually

² In the Matter of Ian Fishman and Lawrence Fishman, Securities Exchange Act Release No. 40115 (1998).

³ See, e.g., Securities and Exchange Commission v. Wheeling Pittsburgh Steel Corp., 482 F.Supp. 555 (W.D. Pa. 1979), vacated and remanded, 648 F.2d 118 (3d Cir. 1981).

sound. The Commission staff will review the effectiveness of these surveillance programs as part of the routine inspection and examination process.

In sum, we are committed to working with the NASD to address the situations identified in the Morgenson article, whether they are caused by systems constraints or manipulative intent.



Mary L. Schapiro
President

February 7, 2000

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
U.S. House of Representatives
Rayburn House Office Building, Room 2125
Washington, D.C. 20515-6115

Dear Congressman Dingell:

This letter provides the response of NASD Regulation, Inc. to your letter to NASD Regulation, the Justice Department, and the Securities and Exchange Commission dated January 5, 2000, concerning a recent article in the *New York Times* by Gretchen Morgenson entitled "Chasing Ghosts at Nasdaq." Ms. Morgenson describes a trading strategy referred to as "spoofing" and reports that this strategy has become more prevalent on Nasdaq and that it is responsible, in part, for the increased volatility on Nasdaq. In sum, the alleged "spoofing" strategy involves the placement and immediate cancellation of large quotes by market participants in an attempt to trigger a market movement that the trader then takes advantage of to establish or liquidate a position. For example, a market participant with a long position in a stock may flash a large buy order on an Electronic Communications Network ("ECN") for a matter of seconds, cancel the order, and thereafter sell its stock to market participants who raised their bids in response to the flash quote/order.

Some argue that "spoofing" is not manipulative because a "ghost" quote, regardless of its brief duration, is immediately executable and exposes the market participant behind the quote to the real and substantial risk of purchasing or selling a large quantity of stock. As such, some may view "spoofing" as indicative of the typical gamesmanship engaged in by traders. NASD Regulation believes, however, that spoofing, with the right set of facts, constitutes market manipulation because it is premised on disseminating misleading pricing information to the marketplace in an attempt to artificially impact the market. Accordingly, as detailed below, the Market Regulation Department of NASD Regulation is enhancing its existing surveillance breaks to better detect instances where flash quotes may have triggered a market movement.

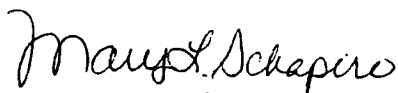
In her article, Ms. Morgenson quotes Meyer Berman, a veteran Nasdaq trader, as saying he "is very concerned about spoofing and the volatility it creates." These same concerns with spoofing were raised by Mr. Berman in mid 1997 with Congressional staff and prompted NASD Regulation's Market Regulation Department to examine trading in several securities identified in a *Forbes* article concerning day trading and market volatility. The review by NASD Regulation staff found that the volatility in these issues appeared to be attributable to news or the execution of large block trades. Since NASD Regulation staff reviewed these securities in late 1997/early 1998, NASD Regulation has received no other complaints concerning spoofing until the recent article in the *New York Times*.

Even though individual complaints about spoofing have not resulted in the detection of rule violations, given the need to protect the integrity of the market and the theoretical and legal possibility that spoofing constitutes manipulation, NASD Regulation is planning to leverage its existing regulatory technology to develop a sequence-based pattern to detect potential manipulative spoofing. Specifically, we are in the process of developing a new scenario in our Advanced Detection System ("ADS") that will generate alerts if there are large quotes/orders for brief periods of time followed by: (1) market movement consistent with the quote/order (*i.e.*, market moves up after a flash quote to buy); and (2) activity on the opposite side of the market by the participant responsible for the flash quote/order. We expect an initial version of this surveillance program to be implemented within the next four to six weeks.

NASD Regulation believes a likely means of flashing quotes is via "non-displayed" orders within an ECN. An order generally can only be displayed in an ECN and not the entire marketplace if the order is priced away from the best bid or offer in the ECN (*i.e.*, orders to buy priced below the highest bid in the ECN and orders to sell priced above the lowest offer, so-called "away from the market ECN orders"). Because of the limited transparency of away from the market ECN orders, the risk that such orders would be executed within one or two seconds is much less than if the orders were exposed to the entire marketplace. Accordingly, we plan to include OATS information about "away from the market ECN orders" along with quotes displayed on Nasdaq in the break detection system for spoofing. OATS is an acronym for NASD Regulation's Order Audit Trail System, which became operational in March 1999. OATS provides us with information on the life of an order, even if the order is never publicly displayed on the Nasdaq Stock Market. Use of OATS data to detect "spoofing" will represent one of the first times we have integrated OATS information into our surveillance system, which information did not truly become available from a reliability standpoint until late 1999.

NASD Regulation takes very seriously the allegations raised in Ms. Morgenson's article and we will be devoting technological and staff resources to ensure that such activity is detected if it occurs to preserve the integrity of the market and the protection of investors. In addition, NASD Regulation staff would be pleased to provide Congressional staff with a briefing of our surveillance efforts in this area.

Sincerely,



Mary L. Schapiro
President



U.S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

FEB 7 2000

The Honorable John Dingell
Ranking Minority Member
Committee on Commerce
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Dingell:

This responds to your letter to the Attorney General concerning a recent print report on a market manipulation scheme known as "spoofing." According to the New York Times column enclosed with your correspondence, some veteran traders theorize that volatile swings in the market prices of certain stocks are the result of spoofing schemes in which traders place large buy orders on electronic trading systems and withdraw them seconds later. The column explains that these "phantom" bids lure other traders to join the buying wave. As unsuspecting investors join in the buying wave, the original traders have withdrawn their orders and are selling at prices inflated by the buying wave.

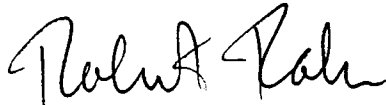
Your correspondence indicates that you also have written letters about spoofing to the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers Regulation, Inc. (NASDR). As the primary securities regulatory and self-regulatory authorities, respectively, they are uniquely qualified to offer an assessment of spoofing and its possible relationship to market volatility. Although we are not aware of any of the U.S. Attorneys' Offices, to date, having occasion to bring a case for the activity you describe as spoofing, the Department's continuous liaison with the SEC and the NASDR ensures that market abuses that warrant possible prosecution, which may include suspected spoofing schemes, are brought to our attention in a timely manner.

The Department, in close coordination with the SEC and the NASDR, is aggressively investigating and prosecuting market manipulation frauds, as well as broker bribery and offering misrepresentation cases. Last year, for example, more than ninety market professionals were charged in federal indictments in connection with manipulation schemes. We thus believe that our enforcement efforts are responding effectively to these and

other criminal schemes that victimize investors and threaten the integrity of our securities markets.

Thank you for your interest in the Department's securities fraud enforcement program. Please do not hesitate to contact us if we can be of further assistance with regard to this or any other matter.

Sincerely,



Robert Raben
Assistant Attorney General

cc: The Honorable Thomas J Bliley, Jr.
Chairman, Committee on Commerce

The Honorable Michael G. Oxley
Chairman, Subcommittee on Finance
and Hazardous Materials

The Honorable Edolphus Towns
Ranking Minority Member
Subcommittee on Finance and
Hazardous Materials